No. 15898

United States
Court of Appeals
for the Ninth Circuit.

ARTHUR V. MORGAN and DOROTHY O. MORGAN,

Petitioners,

-vs-

COMMISSIONER OF INTERNAL REVENUE

Respondent.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONERS

LEONARD B. HANKINS
4014 Long Beach Blvd.
Long Beach 7, California
Attorney for Petitioners.

Harrison-Hartford, Inc., Beverly Hills, California • BRadshaw 2-7888

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JURISDICTION

This appeal by ARTHUR V. MORGAN and his Wife, DOROTHY O. MORGAN is taken from the decision of the Tax Court of the United States (Arthur V. Morgan and Dorothy O. Morgan, Petitioners vs. Commissioner of Internal Revenue, Respondent - Docket No. 56621, filed October 17, 1957; Cited 29 T. C. No. 9), which held that there is a deficiency in income tax for the

calendar year 1950 in the amount of $4,076.40. The petition for review was filed January 7, 1958 (R. 38). Jurisdiction is conferred on this court by Section 7482 of the Internal Revenue Code of 1954.

STATEMENT OF CASE

History of Case

This action was brought in the Tax Court of the United States by Arthur V. Morgan and his Wife, Dorothy O. Morgan, against the Commissioner of Internal Revenue seeking a redetermination of an income tax deficiency by the Commissioner against taxpayer for the calendar year 1950.

The case was heard before the Tax Court of the United States at Los Angeles, California, before the Honorable Craig S. Atkins on January 11, 1957, on a stipulation of facts as well as oral testimony.

The Tax Court rendered its findings of fact and opinion on October 17, 1957, upholding the deficiency determined by the commissioner. The decision of the Tax Court was entered on October 17, 1957.

It is from this Opinion and Decision that this Appeal is taken.

QUESTION PRESENTED

The assignments of errors contained in the Petition for Review raised primarily the following question:

Is that portion of the interest which a purchaser

of an automobile under a conditional sales contract agrees to pay according to its express and implied terms and which portion the bank agrees to pay to the automobile dealer who sold the car as consideration for guaranteeing the obligations of the purchaser as well as further consideration for selling the conditional sales contract to the bank and which sums the bank agrees to pay to the dealer is determined under a complicated formula and cannot be determined until after collections have been made on the contracts for some period of time, income to an accrual basis taxpayer at the time the conditional sales contract is assigned, transferred or pledged to the bank, or is it income at the time the sum of money payable by the bank to the dealer is determinable and payable to the dealer?

RESUME OF FACTS

The petitioners are husband and wife, residing at Long Beach, California. Their joint income tax return for the year 1950 was filed with the Collector of Internal Revenue for the Sixth District of California. The Petitioner, Arthur V. Morgan, will hereinafter be referred to as dealer or taxpayer (R. 20).

The taxpayer and Frank D. Lortscher formed a partnership doing business as ART MORGAN MOTOR COMPANY (hereinafter referred to as the partnership) in Long Beach, California on January 7, 1950. Taxpayer held a

75 percent interest and Lortscher held a 25 percent interest. The partnership kept its books and records on an accrual method of accounting. It filed its income tax returns for the taxable period January 7, 1950 to December 31, 1950, with the Collector of Internal Revenue for the Sixth District of California (R. 20-21).

The partnership was actively engaged in the purchase and retail sale of used automobiles. A large number of automobiles were sold under conditional sales contracts. In all such sales the conditional sales contracts were simultaneously assigned by the partnership to Farmers & Merchants Bank, Long Beach, California, hereinafter referred to as the bank. (R. 21)

The forms used in the making of conditional sales were furnished by the bank to the partnership. In all conditional sales contracts purchasers agreed to pay the amount designated therein as the "Contract Balance", which is made up of the several items set forth in the example given below. The purchaser agreed to pay the amount of the contract balance in equal successive monthly installments at an office of the bank. The contracts provided that title to the car should remain in the dealer until all payments were made and all conditions of the contract were complied with. Two forms of assignment were used by the partnership in assigning the contracts

to the bank. Under one form the assignment was made "with recourse" and the other was made "without recourse". (R.21)

From January 7, 1950 to July 1, 1950, the partnership assigned contracts to the bank under the form which bore the caption "with Recourse" and from July, 1950 until the end of the year it assigned contracts under the form designated "Without Recourse". (R. 21). However, the form of assignment which provided "Without Recourse" was supplemented with a form of agreement providing that the dealer would nevertheless guarantee the contract. The dealer guarantees all the paper assigned to the bank. (R. 71)

From January 7, 1950 to July 1, 1950, the partnership assigned numerous contracts to the bank under these forms of agreements. (R. 21-22)

The following example is typical, except for the amounts of the conditional sales contracts entered into between the partnership and the purchasers of used cars during the year 1950:

1.	Cash Purchase Price	$ 2,795.00
2.	Sales Tax	83.85
3.	Total Cash Purchase Price	2,878.85
4.	Less: Down-payment	1,645.85
5.	Unpaid Cash Purchase Price	1,233.00
6.	Add: Motor Vehicle Tax	40.00
7.	Unpaid Balance	$ 1,273.00
8.	Add: Time Price Differential (Finance Charges or Interest)	143.15
9.	Contract Balance	$1,416.15

Upon assignment of a contract containing the figures in the example above set out, the bank would immediately pay to the partnership the amount of $1,233.00 shown as Item 5 and designated "Unpaid Cash Purchase Price". Item 6 in the amount of $40.00 representing motor vehicle tax, would be paid by the bank either to the partnership or directly to the Department of Motor Vehicles depending upon whether the partnership or the bank cleared the title to the car. Item 8, designated as "Time Price Differential consisted of finance charges or interest, and was variable depending upon what the partnership saw fit to charge the purchaser. (R. 23-24). The remainder of the time price differential would be credited to the dealer's reserve account. In the example the "Time Price Differential" of $143.15 would be divided as follows:

1. $75.90 to the bank of which the bank would take $5.00 as earned discount and $70.90 as unearned interest.
2. $67.25 credited to a dealer's reserve account. (R. 54-55).

The entries in the dealer's reserve account on the books of the bank were recorded by the partnership in a memorandum account. The partnership did not record such entries in a general ledger account nor did it reflect them in any of its financial statements. The bank informed

the partnership of entries made in the reserve account and periodically sent the partnership statements showing the balance in such account. (R. 25).

During the year 1950 some of the purchasers under contracts which the partnership had assigned to the bank paid off the contracts prior to their normal maturity dates and accordingly under the applicable state law were not obligated to pay the entire sum designated "Time Price Differential", but only a lessor sum. In these circumstances, the bank debited the reserve account for the portion of the sum that was no longer due from the purchaser. (R. 25-26)

In the above example of a 15-month contract, if the purchaser paid up the contract in six months, the bank would reduce the amount of the time price differential by the sum of $44.20 of which $22.83 would be entered in its unearned discount account and $21.37 would be charged to the dealer's reserve account. (R. 27).

The following schedule sets forth, with respect to some of the contracts assigned by the partnership to the bank, the date and amount of the original credits by the bank to the reserve account, and the dates and amounts of the debits to such account in instances of prepayments by the purchasers of cars:

Name of Car Purchaser	Credits to Reserve Account Date	Amount	Debits to Reserve Account Date	Amount
Finley	1/21/50	29.90	2/17/50	19.90
Williams	3/27/50	15.40	6/ 3/50	2.20
Barker	6/ 1/50	106.00	7/15/50	88.32
McConnell	5/27/50	49.35	7/20/50	30.00
Barrett	6/20/50	52.24	6/29/50	52.24
Welch	4/14/50	84.21	8/10/50	56.01
Van Meter	7/14/50	50.80	8/16/50	37.53
Kennedy	8/ 2/50	107.57	8/18/50	94.37
Schuler	8/ 4/50	211.55	8/29/50	153.40

The above schedule is merely illustrative and does not set forth all instances where prepayments were made by purchasers. (R. 27).

In determining whether a dealer was entitled to withdraw any amount from the reserve account, the bank deducted from the amount of the reserve the full amount of the partnership's recourse liability on any delinquent accounts and repossession. During the year 1950, the credit balance in the reserve account of the Art Morgan Motor Company, reduced on account of delinquencies and repossessions, never exceeded ten percent of the aggregate unpaid balances of the contracts that has been assigned by the partnership to the bank. The partnership was not entitled to receive and the bank was not required to make and did not make any payments to the partnership in pursuance of the terms of the agreement. At all times

material the bank was financially sound and was able to pay any amount due to the partnership. (R. 27-28).

During the taxable year the credits to the reserve account totaled $16,895.08 and the debits thereto totaled $1,130.76, leaving a credit balance of $15,764.32 at the end of the year. (R. 28).

The partnership did not report as income for the period in question any of the credits to the reserve account or any of the $15,764.32 credit balance therein; nor did it report any of the debits as a deduction. The partnership did not claim a bad debt deduction for the taxable year in question. (R. 28).

In determining the deficiency, the respondent increased the partnership's income for the taxable year 1950 by the sum of $15,764.32, representing the credit balance in the reserve account as of the end of the taxable period 1950, and as a consequence increased the petitioner's distributive share of the income of the partnership. The respondent also held that the $15,764.32 item did not constitute a deductible item to the partnership under any provision of the Internal Revenue Code of 1939. (R. 28-29).

SPECIFICATIONS OF ERRORS

1. The Tax Court erred in that it held that amounts retained by the bank as purchaser of an automobile

dealer's deferred payment contracts and credited to a reserve account on the books of the bank to be accruable income to the dealer in the year of the sale of the contracts even though the amounts of the reserve at the close of the year was not sufficient to allow the dealer to demand payment of any part thereof.

2. The Tax Court erred in entering its order and decision that there is a deficiency in petitioner's income tax for the calendar year 1950 in the amount of $4,076.40 or in any other amount.

3. The Tax Court erred in that its decision is not supported by the evidence.

4. The Tax Court erred in that its decision is contrary to law.

ARGUMENT

RESUME OF ARGUMENT

The bank in addition to paying the dealer the cash balance due on a conditional sales contract, agreed to share with the dealer part of the interest as it was earned under specific terms and conditions in consideration for the dealer guaranteeing that the conditional sales contract would be performed according to its terms. Since the amount of this unearned interest which the bank had agreed to share with the dealer could not be determined until the happening of certain contingencies which

did not occur during the taxable year in issue and since the dealer under the terms of the contract with the bank had no right to receive any amount of the interest, there has been no income to the dealer from such interest during the year in issue.

ARGUMENT

Before the ultimate decision can be determined by this Court, consideration is going to have to be given to secondary issues presented in this case. These secondary issues which the court must consider are as follows:

1. What is gross income?

2. When does income accrue?

We will consider these secondary issues in the order mentioned.

FIRST: It is necessary for us to determine whether, under the rules of taxation which have been laid down by Statutory and Case Law, the amounts which the commissioner has determined that should be added to the petitioner's taxable income is actually gross income and taxable under the law applicable thereto.

Section 22(a) of the Internal Revenue Code of 1939 defines gross income to include "gains, profits, and income" derived from a long list of sources mentioned and then ends by including in gross income "gains or profits and income derived from any source whatever". This

section in effect, includes in gross income all items that are constitutionally income and that are not excluded by the provisions of some other section.

The Supreme Court of the United States in the case of EISNER v MACOMBER 252 U.S. 189, 40 S. Ct. 189, stated that income is that gain which is"---received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal....". In the instant case the amounts which the commissioner has attempted to add to the income of taxpayers, represents mere bookkeeping entries upon the books and records of the bank. (R. 17, 18, 58, 68, 69, 109). These sums do not reflect a true liability of that bank to the taxpayer. (R. 109). They are merely entries made by the bank in order that after certain additions and subtractions are made (which items may or may not occur) the resulting balance may or may not reflect a liability to the dealer, since it cannot be determined whether or not there will be any liability to the dealer until after subsequent events occur. (R. 16, 53, 69). These mere bookkeeping entries do not come within the definition statutory or by case law of gross income. Therefore, since this issue must be answered in the negative, the commissioner has erred in taxing these amounts to the taxpayer and the Tax Court likewise has erred in sustaining the commissioner's position. However, assuming

for purposes of argument only, that these amounts of bookkeeping entries are gross income within the purvue of the law, we then must consider the next question.

SECOND: Our next secondary issue which must be determined is: Assuming that the commissioner has correctly determined that the amounts represent gross income of the taxpayer, then in what year is the taxpayer required to report the same as income when the taxpayer is on the accrual method of accounting? That is, when does income accrue when the money has not been received by the taxpayer?

In the case of H. LIEBES AND SEAL v CIR 90 F. 2nd 932, 936 (9 CCA 1936) it was stated the "Act (Internal Revenue Code) does not defiie nor provide when income accrues". Therefore, we must look then to the court decisions in order to determine how and when items of gross income accrues in order that we may determine the year of taxability of such income.

In LUCAS v NORTH TEXAS LUMBER CO., 281 U.S. 11, 50 S. Ct. 184, the Supreme Court held that income does not accrue until there is an unconditional liability of someone to pay it to the taxpayer. In the instant case there certainly was a conditional liability upon the bank to pay any of the time price differential to the dealer because of the numerous contingencies which until the events

occurred, there was no liability upon the bank to pay. (R. 16, 53, 69). These contingencies involved (1) the payment of the interest or time price differential by the purchaser to the bank (2) whether the total unearned interest as set forth on the contract would be reduced because the California law requires that the total unearned interest to be reduced in case of prepayment which in case the contract is paid before its regular maturity date; (3) the contingency of the dealer fulfilling his guarantee of the contract; (4) pay-offs due to repossessions which would reduce the amount payable as interest to the bank; (5) the contingency of the total outstanding contracts being less than 10% of the net sums of the remaining balance in the so called reserve account. (R. 16, 53, 69). Since all of these were contingencies, the mere bookkeeping entries made by the bank on its books certainly is not an unconditional liability of the bank to the dealer at the time it is made; therefore, there is no accrual until there is that unconditional liability which would only come about at the time when under the contract with the bank there is this unconditional liability to pay a sum certain. In this case it is of importance to notice that in the stipulation of facts (R. 17) that the total additions to the dealer reserve account on the contracts represented therein equals to $707.02 and that

the dealer's share of this original computed interest was reduced by $533.97 due to payoff's on these contracts prior to the maturity date. This is a 75.5% reduction from the original share allocated to the dealer by the bank in its first allocation of the unearned interest. Certainly this great percentage in reduction shows that it is impossible to determine within any reasonable certainty what, if anything, the dealer is entitled to receive and therefore no amounts should be accruable as income until this can be determined.

The Supreme Court in the case of CONTINENTAL TIE & LUMBER CO., v U. S. 286, U. S. 290, 52 S. Ct. 529, held that income accrues when there is a right to payment. In the instant case there was certainly no right to any payment by the taxpayer during the year 1950 nor was there any duty on the part of the bank during this year to make any such payment. Neither did the taxpayer have an unqualified contractural right in the taxable year to demand or receive any of the amounts which the commissioner has determined to be income of the dealer (R. 28). Of the total which the commissioner has determined to be income of the taxpayer there is no way to determine what portions of these amounts, if any, would ultimately be received by the taxpayer.

In NORTH AMERICAN OIL CONSOLIDATED v BURNETT 286

U. S. 417, 424; 52 S. Ct. 613, 615, the Supreme Court said:

> "If a taxpayer received earnings under a claim of right and without restrictions as to his disposition he has received income which he is required to return even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent."

In the instant case the taxpayer has received no moneys under a claim of right during the year in question. In fact, under the agreement between the taxpayer and the bank he had no claim of right to any portion until the share of the interest agreed to be paid to him from each contract exceeded 10% of the outstanding liabilities of all contracts and not until that contingency occurs, could it be said that the taxpayer had a claim of right to any sums of money.

The Supreme Court in the case of SPRING CITY FOUNDRY CO. v CIR 292, U. S. 182, 184, 54 S. Ct. 644, 645 in discussing the problem of accrual of income and as to the problem when it accrues stated as follows:

> "Keeping accounts and making returns on the accrual basis as distinguished from the cash basis, imports that it is the right to receive and not the actual receipt that determined the inclusion of the amount in gross income. When the right to receive an amount becomes fixed the right accrues."

Again the taxpayer having no right to receive any sums of money from the bank for the simple reason that it could not in any way be determined what if any would ever be paid by the bank to the dealer as compensation for guaranteeing the notes, there should be no accrual to the taxpayer of any income during the taxable year 1950.

In cases wherein sums of money may be payable but are dependent upon contingencies whereby the taxpayer may never in the future ever receive those funds no sums are reportable as income until the sums can be adequately determined. This is so held in the case of CIR. vs. CLEVELAND TRINIDAD PAVING CO. 62 F. 2d 85, affirming 20 BTA 772. The court stated in essence that a taxpayer on the accrual basis is not required to include in income sums to be received in the future where there is a substantial contingency as to the amount to be received or the time of its receipt. In LYNCHBURG TRUST AND SAVINGS BANK v CIR. 68 F. 2d 356, CERT. DEN. 292 U. S. 640 the Court stated:

> "Taxpayers generally are charged with income not reduced to possession, but only if it may be said that the income is received constructively and has become so far subject to the taxpayers demand that its non-receipt is a matter of his own choice".

In the instant case it cannot be said that the taxpayer has constructively received any income for the simple reason he did not have the right to demand any sum

of money from the bank during the year in question and consequently for that reason the income is not accruable during the year 1950. Courts have continually held that income is not accruable to an accrual basis taxpayer which may never be received or where the taxpayer does not have an unqualified right until the happening of some contingency (GREAT NORTHERN RAILWAY CO. 8 BTA 225; STONER v CIR. 79 F 2d 75 (3 CCA 1935 CERT. DEN. 296 U.S. 65); MARION H. McARDLE 11 TC 960 (1948); ESTATE OF MARGARET McALLEN FAIRBANKS, 3 TC 260 (1944); E. P. MADIGAN, 43 BTA 549 (1941); SARAH R. PRESTON, 35 BTA 312; SEWARD PROSSER 7 BTA 734). From these cases it is easy to formulate the rule that an item of income shall be accrued when but not until all events have occurred which are necessary to fix the liabilities of the parties and to determine the amount of such liabilities. This rule requires that there be no remaining unsatisfied conditions precedent.

The case of COMMISSIONER OF INTERNAL REVENUE v HANSEN, et al and the companion cases, 360 U.S. 466, dealt with the issue of accruability of income to a dealer from what has become known as "dealer's reserve". In the HANSEN and related cases the factual situation was that a dealer was to be paid a certain sum of money by the finance company for a conditional sales contract assigned

by the dealer to the finance company. The finance company then would withhold 5% of the sales price, give the dealer 95% and place the 5% into a "dealer's reserve" account. Thus, in these cases a sum of money was withheld from the sales price. However, in the case now before the court, we have an entirely different situation and completely distinguishable by its facts. In the instant case, there was nothing withheld from the sales price given the dealer. The facts show that the dealer assigned, transferred or pledged the paper to the bank and the bank gave the dealer the balance of the cash price (R. 24) except in certain instances when the bank did not believe the contract balance after the cash payment by the purchaser was sufficient (R. 69, 70, 83). In these latter instances the bank would withhold certain sums from the dealer pending final reduction in the account by the purchaser at which time the bank would release these withholds to the dealer (R. 69, 70 , 83, 84). These withholds are not in issue in this case. In the case now before the court the bank, in addition to paying the dealer the cash balance of the purchase price of the car for the paper from which there was nothing withheld, agreed to share part of the interest as it was earned with the dealer under specific terms and conditions in exchange for the dealer guaranteeing the

purchaser's liability to the bank.

From the following testimony which appears in the record, it is apparent that the bank agreed to share with the dealer (taxpayer) part of the interest charge on the contract in exchange for the dealer bringing his conditional sales contract to the bank and as consideration for the dealer guaranteeing the conditional sales contract:

Findings of the Court: "Purpose of the bank in maintaining the dealer's reserve account were to provide security for the payment of the assigned contracts and to induce the dealer to discount contracts with it". (R. 25)

Q: Mr. Simpson, do you know whether or not the purpose in setting up this dealer's reserve account for the dealer is for the purpose of getting the dealer to guarantee the paper to the bank?

A: Yes, I know. (R. 71).

Q: Would you state whether it is or not for the purposes of securing the guarantee by the bank of the paper which is assigned by the dealer to the bank?

A: I would say it is one of the reasons. (R. 71,72)

Again from Pages 77-79 of the Record where the witness from the bank to whom the taxpayer sold its conditional sales contracts was under rigid cross-

examination by the Government Attorney, the attorney was attempting to determine from the witness what would happen if there was no unearned interest (time price differential) added to the contract with which to split with the dealer and the witness at the bottom of Page 79 and top of 80 of the Record replied as follows:

> "We would not be able to ask the dealer to sign the contract "with recourse", therefore, it would become a direct bank deal, there would be no liability on the part of the dealer on the occasion of repossession or default."

From page 93 from the same line of questioning by the Government Attorney, the witness gave the following answer:

> "-----I have never known a dealer to guarantee a contract unless he got paid something in his dealer's reserve account and as I think I mentioned before, if we bought such a contract it would have to be on a direct bank deal, it could not be guaranteed by the dealer, it would be the bank's deal with the purchaser and then we would consider a direct bank loan and we would not charge four and one-half percent, we would charge six percent".

From the record on pages 116-119, appears the following pertinent testimony:

> Q: If a party not a dealer brings in a contract to your bank covering the sale of a car on a conditional sales contract, would you charge that non-dealer the same amount of the time

price differential portion as you would a regular dealer? (R. 116).

A: We would charge a higher rate.

Q: Generally why would you charge a higher rate than you would a dealer? (R. 116)?

A: The dealer brings contracts into us in certain volume, depending on the dealer, and he is entitled to more consideration ratewise than the individual purchaser. (R. 116).

Q: If a non-dealer were to bring in a contract to you at the same figures that we have above here on our typical transaction (this was referring to a typical sales contract given by stipulation on R. 16) would you give him anything else for the contract over and above what your normal discount rate would be non-dealer? (R. 117-118)

A: By that contract at our direction, direct bank rates to individual purchasers which would be at six percent and there would be no other credits than to your unearned discount (R. 118).

Q: In other words you would not set up any portion of any reserve for this particular non-dealer? (R. 118).

A: No reserve set up (R. 118).

Q: If a non-dealer were to bring you a contract similar to the same identical figures on it as we have on our typical transaction would you ask him to guarantee that paper? (R. 118).

A: No if another dealer who was not on our books under a dealer agreement, dealer's reserve,

brought us a contract, first of all we would not take his contract, we would tell him we would buy the paper if the customer would com in with his order and then we would write the contract from our bank at our rate of interes to a customer. (R. 118-119).

Q: And would that rate of interest be greater th you charge to dealers? (R. 119).

A: Yes, it would. (R. 119).

Q: The reserve account, what is the purpose of the account? (R. 84).

A: To induce the dealer to discount contracts with us, Sir: (R. 84).

Q: And it is to secure the bank? (R. 84).

A: So far as the bank is concerned it is a method of getting business. (R. 84).

The following testimony discloses that this case is different from the HANSEN, et al cases in that when the bank purchased the paper, the bank paid the cash balance (Item 7 of Stipulation of a Typical Transaction R. 16) and did not withhold anything from the dealer.

Q: The contract balance is.....to be exact $1,416.16. Now, then the dealer comes in and asks if you will handle this contract, Mr. Simpson, you would purchase it for the sum, less the bank's normal discount? (R.85,8

A: No. (R. 86)

Q: What sum would you purchase it for? (R. 86)

A: We purchased for Item 7, the unpaid balance. (Note here witness is referring to Item 7 on the Stipulation of Typical Transaction R. 16 of $1,273.00). (R. 86)

Q: Lets run through on that. You would pay $1,273.00 in cash to the dealer? (R. 86)

A: Yes.-----. (R. 86)

The following testimony discloses the method used by the bank and the dealer to determine what if anything the dealer will eventually get as his share of the interest:

Q: Would you describe the procedures used by the bank in handling that amount? (Note this refers to the $143.15 time price differential interest which appears as Item 8 on the Typica Transaction set out in the Record on Page 16). (R. 54).

A: We would arrive at a charge determined by the rate that we were charging the dealer and would take the charge and subtract it from the time price differential on Line 7 - on Line 8 and credit the balance to the dealer's reserve account. (R. 54)

Q: Have you made a breakdown of those figures, the computation that the bank makes for this $143.15? (R. 54).

A: Yes, I have.

Q: What is the breakdown that you have computed? (R. 54)

A: The bank charges would be $75.90 and there would be credited to the dealers account, $67.25 to the dealer's reserve account. (R. 54).

Q: If this contract had been paid off after six payments, would the bank make any adjustments in its records? (R. 56)

A: Yes. (R. 56)

Q: Assuming that this contract was a fifteen month contract and it was paid off in six months, have you made any computation to show what adjustments the bank would have made on its records?

A: Yes, I have.

Q: What are those? (R. 56)

A: There would be a refund of unearned charges in the amount of $44.20. (R. 56)

Q: What else does the bank do? (R. 56)

A: Since the bank has refunded charges it had previously collected they can split up that refund between that portion of the refund that the bank would charge itself and that portion that they would charge to the dealers reserve account. (R. 56).

Q: Have you made the computations of what figures would be represented? (R. 56)

A: Yes, in this particular case, $21.37 would have been charged to the dealer's reserve account and $22.83 to the bank unearned discount. (R. 56-57)

THE COURT: That means that you would have earned that much less than you thought you would earn? (R. 57)

THE WITNESS: Right (R. 57)

Q: Then the dealer would lose or his earnings would be $21.37 less than the original share? (R. 57)

A: Thats right. (R. 57)

Q: Is this $67.25 that you put into this dealer's reserve account, is that subject to the dealer's withdrawal immediately? (R. 57)

A: The dealer has no control over the account whatever. (R. 58)

Q: In essence, then you take your time price differential and the dealer and the bank shares in that? (R. 58)

A: Thats right.(R. 58)

Q: In other words, this original $67.25 of the time price differential which you put into the dealer's reserve account is subject to other computations before you can determine what, if any, portion is due the dealer; is that right? (R. 59)

A: Correct. (R. 59)

Q: But the total of all figures that go into this reserve account, you make subsequent computations of taking ten percent of outstanding balances, add to that all the contract accounts over thirty-five days past due and if he has any excess, he has a right to receive that; is that

correct? (R. 64)

A: Right. (R. 65)

Q: Mr. Simpson, you mentioned in your testimony that there was no money represented by these credits to the dealer's finance reserve, for example the $67.25, that was only a bookkeeping entry on your books. What, if anything must happen before the dealer would ever be entitled to receive any of this money in the dealer's finance reserve? (R. 68).

A: There would have to be some collected balances, money received. (R. 68)

Q: In essence, then Mr. Simpson, this is merely a first allocation of $67.25, that is merely a bookkeeping record in the bank to determine what ultimately under your contract may be paid to the dealer; is that correct? (R. 69)

A: That is correct. (R. 69)

Thus, in this case there was nothing withheld from the sales price of the paper. This is entirely another transaction, to wit: the bank paid the dealer the cash price which is the market value of the contract at the time that it was assigned. This amount was reported by the dealer and is not an issue. The amount of the unearned interest which the bank agreed to share with the dealer under specific terms and conditions is that which is in issue and constitutes a separate item entirely and is therefore distinguishable from the HANSEN cases. There-

fore, the principal as laid down in the HANSEN case is not applicable to the case before the court. In fact, the Supreme Court specifically and expressly left open the question which is involved in this case. In the HANSEN, et al cases, the Supreme Court stated:

> "The taxpayers have argued that portions of the dealers reserve accounts consist of percentages of finance charges, which the finance companies agreed to allow them, and that such percentages of the finance charges not being part of the purchase price of the installment paper should in no event be regarded as accrued income to the dealers".

The Supreme Court in that case stated that since it had no evidence regarding this issue presented by the taxpayers, those taxpayers in the HANSEN case had failed to carry the burden of proof. Thus, this issue was therefore left open by the Supreme Court.

In fact, the issue presented in the instant case is similar to that which was before the court in KEASBEY & MATTISON CO. v U.S. 141 F. 2d 163 (3 CCA 1944). In the KEASBEY & MATTISON case, the taxpayer sold asbestos products for house improvements to dealers and distributors, who in turn sold to retailers, the retailers then in turn sold to home owners who executed notes for the unpaid balance of the purchase price. When the FHA who had previously guaranteed the financing termin-

ated these guarantees, the taxpayer then arranged with the finance company to accept these notes. The finance company then agreed to discount the notes at the rate of 7%, 5% of which the finance company would retain and the other 2%, the finance company placed in a reserve account. Out of this reserve account would be charged certain losses which the dealer had guaranteed and then the remainder, the finance company would pay to the dealer under the following formula: When the outstanding liabilities were less than 10% of the amount in the reserve 2% discount account, the finance company agreed to pay to the dealer these sums for guaranteeing the contracts. In that case the commissioner accrued as income to the taxpayer those amounts which were set aside in the 2% reserve account and assessed a deficiency against the taxpayer. On appeal from the District Court which held for the commissioner, the Third Circuit of Appeals held that the sums payable; if anything out of the 2% set aside in the reserve account whereby if certain conditions happen, the dealer would be entitled to some sums of money, was not income to be accrued to the dealer when these credits to this account were made; the taxpayers' rights to these credits at that time was not fixed but were contingent upon subsequent events. In fact, the court stated that "whether the plaintiff would ever acquire a fixed

right to receive anything from the reserve fund was contingent and unascertainable throughout the taxable year". The instant case is even more stronger than the KEASBEY & MATTISON case, because there is no doubt in the instant case but that there was a sharing between the bank and the dealer of the finance charges ultimately to be earned. These certainly could not be shared, and were not to be shared by the bank with the dealer until they were earned. As testimony in this case clearly shows, the sharing was consideration for the dealer guaranteeing this paper; that was substantially what happened in the KEASBEY & MATTISON case. Consequently that case as well as the instant case is completely distinguishable from the HANSEN, et al cases. During 1950, the Appellant's right to receive anything from the finance charges or unpaid interest was contingent and unascertainable. Consequently the Tax Court was in error in upholding the commissioner's attempt to accrue as income that portion of the unearned interest which the bank had agreed under a complicated formula to share with the taxpayer as consideration for his guaranteeing the automobile purchaser's liability under the conditional sales contract.

The unearned interest in the instant case had not accrued to either the bank or the dealer until it was earned was explicitly recognized by the bank and its

bookkeeping procedure. At the time the contract was purchased, the bank entered the dealers pro rata share of the unearned charges in its dealer's reserve account. When the contract was cancelled for the reason of a repossession or reason of prepayment of the contract, the bank would then r duce from its unearned discount account that portion of une ed discount applicable to the cancelled portion of the unea interest. A portion was then reduced from the dealers shar of the dealers reserve account and by so making these additions and reductions from the dealers reserve account of this unearned interest, the bank was able to determine what portion if anything, was payable to the dealer which he had a right to receive under the contract with the bank. (R. 53 69). A similar method of accounting was used to account fo unearned interest in the case of TEXAS TRAILER COACH, INC. COMMISSIONER OF INTERNAL REVENUE, 27 TC 575. The court in speaking of the time of sale and the accruing of interest on the contract states as follows:

> "At this time the sale of the trailer had been earned; there is an unconditional right to receive the selling price. The finance or time charge has not been earned, it will be earned over the life of the contract. When the contract is assigned, the finance company rather than the dealer earns and is entitled to the finance charge."

Therefore, since the amount of unearned interest which the bank agreed to share with the dealer when collected from the purchaser of the auto could not be ascertained during the year before this court, there was no income taxable to the dealer. Even considering that it could be ascertained, since it had not been earned, it was not gross income taxable to the dealer during the year in question. The Appellant contends that the Tax Court erred in this regard and that the decision of the court should be reversed by this court determining that taxpayers income should not include any of the unearned interest which the bank agrees to share with the dealer until the dealer has the right to receive some amount which is definitely ascertainable.

WHEREFORE, Appellant respectfully prays that this Court reverse the decision of the Tax Court of the United States.

Respectfully submitted,

LEONARD B. HANKINS

Attorney for Petitioners.

CERTIFICATE OF SERVICE

It is hereby certified that service of four (4) copies of this brief has been made on opposing counsel by mail in accordance with the rules of the United States Court of Appeals for the Ninth Circuit.

Dated: October 2, 1959.

Leonard B. Hankins